Groves & Partners

Due Diligence for Business and Company Acquisitions: A Comprehensive Reference Guide.

Table of Contents

Due Diligence – A General Overview 3

What Investigations Should be Undertaken During Due Diligence? 3

The Key Questions 4

Assessing Risks: Due Diligence Investigations and Analysis 6

The Business and Transaction 7

Financials 9

Customers and Clients 10

Employees and Management 11

Assets, Inventory and Leases 12

Technology and Patents 13

Suppliers 14

Corporate Matters 15

Environmental Issues 16

Other Factors 17

Due Diligence Report 18

About Groves & Partners 19

Due Diligence Advisory Practice 19

Find Out More 19

Due Diligence – A General Overview

The due diligence process is dynamic and varies significantly from transaction to transaction. Herein however, we outline a general overview which aims to answer some of the frequent questions we get asked regarding the nature of due diligence.

What Investigations Should be Undertaken During Due Diligence?

The due diligence process is never a one-size fits all approach; however common items that may need to be examined include:

Due Diligence Investigations and Analysis

- The historical and projected financial performance of the business.
- The make-up of the business' customer or client base.
- The nature of contracts under which activities of the business may be bound.
- The nature of supply arrangements held by the business.
- Compliance of the business with government regulations.
- Risks inherent in the employees and management of the company, and;
- The nature of property, plant and equipment owned or leased by the business.

It is important to note that the actual due diligence investigations performed will inevitably vary significantly pending the nature of the transaction under consideration, hence it is always important to seek out professional advice prior to commencing your due diligence investigations.

The Key Questions

How Long Does the Due Diligence Process Take?

The process of due diligence is filled with variables, and the time taken to complete a due diligence investigation is one such variable.

Typically, there are several factors that will impact on the time taken to complete a fit-for-purpose due diligence investigation, including:

- The ease of accessibility to company and business records and key management team members to adequately undertake the due diligence.
- The number of separate geographies in which the business operates in.
- The responsiveness of professional advisors acting for the selling company.
- The size of the company or business that is for sale.
- The relationship between the selling company and buying company (if any), and;
- The risk tolerance of the purchaser.

Noting the variances, in our experience, we find that the due diligence process will typically take anywhere from 14 days to 60 days to complete.

In our experience, it is not the length of time involved that indicates a reasonable due diligence, rather the nature of investigations undertaken and their outcome.

What Professionals Should You Engage to Advise You During Due Diligence?

Due diligence is a process that touches on all facets of a business' operations and on the nature of the transaction that is being proposed. In this light, it is typically advisable for prudent business and company acquirers to look to engage a strong team of professional advisors early on in their investigations regarding a potential business purchase to guide them.

The team of advisors engaged for due diligence should include professionals with experience and expertise in financial analysis, business valuations, mergers and acquisitions who can work with your established taxation and legal advisors to ensure adequate due diligence is undertaken while ensuring you receive the advice you require to make a sensible transaction and avoid a bad business deal.

The Right Time to Complete Due Diligence?

The short answer is that it depends.

Generally, the most efficient approach to completing a transaction for all parties is for acquirers to undertake an initial review of the opportunity. This is most commonly done through reviewing an Information Memorandum or Prospectus document. These documents commonly outline all basic details about the opportunity, including financial performance, industry insights, employee arrangements, and some detail on the profile of customers and suppliers.

Based on their assessment of the Information Memorandum or Prospectus, quite often an interested acquirer may be able to place an initial, non-binding proposal outlining their opinion of the business' value (often in the form of a rough range), and their wishes for key contract terms should a transaction proceed. As an acquirer, placing forward an initial proposal at such an early stage in the process can be advantageous for a couple of reasons, namely:

1. You can quickly understand whether your proposal is palatable for the selling party, and;

2. You put yourself in a good position to beat other potential acquirers to the negotiating table (and hence dilute competitive tension).

From here, the seller and acquirer can sit down at the negotiating table and discuss whether, in principle, the acquirer's proposal is worthy of working with.

Should the seller and acquirer have a proposal that is worthwhile proceeding with, it is normally then that the due diligence process should begin.

As part of this process, the sellers will normally release additional information in a controlled fashion to enable the acquirer to refine their offer, and to enable ongoing negotiation of contract terms.

The Wrong time to Complete Due Diligence?

For the purposes of efficiency and confidentiality, it is important that Due Diligence is not undertaken until there is a reasonable chance that the seller and prospective acquirer will proceed towards completing the transaction.

On this basis, it is never recommended that due diligence occurs too early during a transaction. Too often, sellers and acquirers will delve into significant detail and undertake a rigorous analysis of business financial statements and other operational records too early in the process. This is normally expensive, time consuming and generally does not assist the acquirer in making an informed decision, or the seller in executing a transaction.

Assessing Risks: Due Diligence Investigations and Analysis

At its heart, due diligence is a process of assessing, understanding, and where possible quantifying risks. In this light, herein we have endeavoured to provide detailed guidance on the typical investigations and analysis that we often undertake as part of our due diligence engagements.

The matters discussed herein, as with all other matters discussed in this document, are general and not exhaustive, hence we do encourage all prospective business or company acquirers to speak with us or another suitably qualified and experienced advisor regarding your circumstances.

The Business and Transaction

As part of any due diligence process, it is vital that potential acquirers seek to understand fully what the business or company does, how it does it and why it is for sale. Below we outline pertinent considerations to be made in this regard.

Why is the Business for Sale?

It is vital during due diligence to ascertain the vendors reasons for selling the business or company.

Typically, investigations of this nature are conducted by speaking with and asking questions of the business owners or company shareholders.

Sometimes as part of these investigations, you may become aware that based on the reasons for the sale, that the business may not represent the sound acquisition opportunity that you first envisaged. If this occurs, you may wish to reconsider your appetite for completing the transaction or maybe re-negotiate key transaction terms.

Have the Shareholders Tried to Sell Before?

It is important to know the history of any previous attempts by the vendors to sell the business in the past.

We recommend conducting research into this matter. Further, it is often prudent to ask questions of the vendor like:

- "How long has the business been on the market for?"
- "Have you had other discussions about selling the business in the past"
- "Why did you not accept previous offers to acquire the business?"

In our experience, if the business has been unsuccessfully marketed for sale in the past this can indicate issues such as a lack of buyer demand for the business, problems with the business and may indicate that the vendors have unreasonable price expectations. These problems may indicate that the transaction may not be a commercially sensible one to complete.

Have Previous Transactions Occurred Between Shareholders or Owners?

We find it valuable to understand the nature of any transactions that have taken place historically between owners of the business or company. In other words, to understand circumstances in the past when owners of the company have sold their shares or interests to other owners of the company or third parties.

In conducting these investigations, we generally review company shareholder registers, including internal records of the company and records lodged with regulatory authorities. Further, we find it important that these investigations allow an understanding to be gained regarding the price and terms of any such transactions, and the reasons behind the transactions.

The nature of any such transactions may provide you with guidance on internal views regarding appropriate valuation metrics for the company or business, and can provide you with an insight into potential risk factors inherent in the asset.

What does the Business Do?

Understanding what the business does is an integral component of due diligence, however, despite the seeming mundaneness of this exercise, in our experience it is often one of the more intricate areas of investigation.

The way in which a business generates revenue, services their clients or customers, and the nature of their product or service offering is vital to understand.

In our experience, it is prudent to conduct thorough investigations into this space, to ascertain multiple factors not limited to:

- If you, as a potential acquirer will have the skills to operate the business;
- To appreciate how the business' activities may be impacted by external factors such as competitor activities and economic factors, and;
- In the case of strategic acquirers, to gauge the degree to which you will be able to realise cost and revenue efficiencies from the acquisition.

What Strategic Plans does the Business Have?

We recommend that potential acquirers gain an overview of the strategic plans of the subject business.

As part of this, it is our opinion that an important start is to ask for a copy of the business' strategic plan if one is in existence. In the absence of a formal plan, we recommend meeting with the business' management to understand the company's plans.

It is important to assess the plans considering current and forecasted economic and industry factors. Further, for strategic acquirers, it is valuable to assess how the business' strategic plans may impact integrating the acquired company into their established operations.

What Locations does the Business Have?

Physical and non-physical locations held by a business impact directly on that business' success, and on the risk profile of a business.

In our opinion, thorough research needs to be conducted into how this factor may impact on the viability of a transaction.

At a basic level, minimum investigations should be undertaken to assess whether, for example, a business holds the requisite licences or development approvals for their operations in particular locations.

What Entities Own the Business?

In our experience, it is important to understand the corporate structure behind a business' operations as part of due diligence.

We recommend asking vendors for an outline of their corporate structure and seeking a proposal from the vendors regarding how they anticipate a transaction being structured considering the nature of their structure.

The nature of the corporate structure in place, and how this is likely to fit into the structure of a proposed transaction can present risks to acquirers. It is vital to ensure that the structure of a transaction allows a favourable (or reasonable) taxation outcome for acquirers, ensures relevant licences of the business can be transferred, and strikes a balance between ensuring an easy to manage transition period post-transaction with the legal and financial risks of assuming ownership of a company or group of companies.

Financials

In our experience, financial analysis and review is integral to the completion of a thorough due diligence. As part of this, potential acquirers must understand how profitable a business has been and is likely to be, the likely cash flows from the business post-purchase and the financial position of the business. With the aid of this knowledge, potential acquirers should then assess whether the terms of the proposed purchase represent a reasonable proposition.

Are the Financial Statements Audited?

In our experience, audited financial statements can be a more reliable guide as to the historical performance of a business or company than unaudited accounts. Despite this, we recommend that financial statements are closely analysed to ensure they accurately represent the true historical performance of the subject asset.

Some of the investigations that can be undertaken include:

- Reviewing business activity statements, bank statements and customer invoices to confirm that sales revenue is not overstated.
- Reviewing payroll records to understand the employment costs of the business.
- Reviewing rental invoices and leases to ascertain the costs associated with these items, and;
- Reviewing invoices and banking records to understand the quantum of other expense items.

If major discrepancies appear during your analysis, we encourage clients to consider whether the transaction will continue to be commercially viable.

What are the Financial Trends?

Although the past is not necessarily the most accurate guide to the future, we often find that a proper analysis of financial trends can be useful to gauge risks associated with the likely future performance of the subject business or company.

As part of this, we will normally consider the trends that appear in major trading statement, profit and loss statement and balance sheet items in recent years. This can lead to several queries or indicate areas that require additional investigation, such as:

- Understanding the reasons underpinning sharp expense increases.
- Understanding the reasons behind swings in revenue between different months or financial years.
- Gaining a better understanding of the business' cash flow through assessing invoice collection cycles and bad debts, and;
- Considering risks inherent in any increases or decreases to the business' sales margins.

What Other Financial Risks Should be Assessed?

In our experience, there are several other financial risks that should be assessed and considered, such as:

- Understanding whether the business' financial performance will be the same under your ownership or different.
- Assessing financial projections of the business and their reasonableness.
- Understanding future capital expenses that the business may need to incur.
- Understanding and quantifying any one-off revenues of the business and how these impact on the business' underlying financial performance, and;
- Considering what information and risks can be understood regarding non-financial risk factors because of your financial analysis.

Customers and Clients

It is our view that an understanding of who a business' customers or clients are, and the risks associated with the business' customer or client base (like the risks of customers not paying invoices or clients ceasing to engage the services of a business) should be understood as part of due diligence.

Understanding Customer Concentration Risks

Business' that have a few customers that contribute heavily to overall revenue are riskier than those businesses with a broader set of customers that more evenly contribute to revenue.

Noting the above, we encourage potential acquirers to consider the revenue contributions of clients to the subject business, with an aim to:

- Understand the risks associated with some clients who may make large contributions to revenue, and;
- Understand the potential growth available from increasing revenue contributions from smaller clients.

Specific Customers and their Risks

It is quite common for different customers of a business to have different risk profiles. Hence, it is vital to understand the risk profile of individual customers, particularly those customers who make significant contributions to a business' revenue.

In understanding the nature of key customers, we recommend at a minimum:

- Reviewing customer contracts (with particular focus on important terms like termination clauses).
- Understanding who in the business holds the primary relationship with major customers, and;
- Assessing the timeliness of payments made by each key customer.

Product and Service Warranties

Product and service warranties can represent a future burden to businesses in terms of both lost time and money. Hence, we advise clients to understand the risks associated with this matter.

As part of assessing this risk, we recommend:

- Reviewing the history of warranty claims historically.
- Understanding the historical cost of warranty claims, and;
- Making a thorough assessment of the risks of future warranty claims.

Employees and Management

Employees and management generally represent a major risk factor when acquiring a business. Our simple view is that potential business or company acquirers should assess whether the operations of the business with respect to employees and management will likely be sustainable post-transaction.

Remuneration and Non-Financial Benefits

The remuneration and benefits offered to employees and management can and often does constitute a major expense of a business.

At a minimum when assessing this risk factor, we recommend considering:

- Gaining a holistic understanding of all remuneration paid to employees and contractors including salaries, wages, superannuation, consulting fees, director fees, bonuses and profit shares.
- Understanding whether the remuneration offered to the employees and contractors of the business is consistent with market normalities.
- The costs and practicalities of non-financial benefits that are provided to employees and management, and;
- Assessing whether the remuneration costs of the business are sustainable.

Understanding Employee Relationships and Personal Goodwill

Relationships held by employees can be risk factors worthy of analysis and investigation during due diligence.

Consider the risks of hypothetical circumstances such as:

- The existence of strong personal relationships held between salespeople and key customers.
- Risks associated with personal relationships held between staff and management and how this may impact on the future performance of the business post-transaction, and;
- The existence of special relationships held by exiting shareholders or owners with key customers or suppliers to the business.

Potential acquirers may find that the existence of these risks may warrant the negotiation of revised transaction terms.

Other Employee and Management Risks

Employee and management risks are many and varied. Some of the other risks worth assessing beyond those detailed above include:

- Whether the business has an employee manual in place (or other employee procedures) and how up to date these items are.
- The nature of employee contracts and any risks inherent in those documents.
- Qualifications held by key employees and how these may coincide with licensing or operational requirements of the business, and;
- Understanding risks associated with historical statistics such as annual employee turnover metrics.

Assets, Inventory and Leases

Investigating asset, inventory and lease matters are of paramount importance as part of due diligence. Herein, we provide an overview of key factors to investigate in these areas.

The Nature of Assets

In our experience, it is vital for potential acquirers to form a strong understanding of precisely what assets are owned by a business or company. Specifically, this understanding should extend to considering:

- When the assets were purchased.
- The nature of any security charges liens or encumbrances held over specific assets and whether these charges can be released as part of the sale.
- Whether it is prudent to seek out expert advice from a plant and equipment valuer regarding the condition, current value and replacement value for assets in order to properly protect yourself as part of your due diligence.
- What the likely ongoing maintenance costs will be for maintaining the assets of the business and whether this is reasonable, and;
- Gaining an understanding of when the assets will need to be replaced.

The Importance of Undertaking a Stocktake

In our experience, it is vital for a stocktake to be completed prior to completing a business purchase. This is important to ensure a fair price is paid for the stock inventory of the subject business, and that this price incorporates the issues associated with stock redundancies and slow-moving stock items.

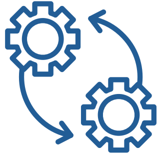
This stocktake may be undertaken during the formal stage of due diligence or following the formal period of due diligence as a confirmatory item prior to finalising the transaction.

In our experience, it is vital that the process for completing a stocktake is agreed to between the parties to the potential transaction in advance. This ensures that the stocktake will be completed with full cooperation and in a seamless manner.

The Importance of Assessing Leases

Leases for real property and other assets should be reviewed in detail as part of due diligence. As part of this review, we recommend considering at a minimum:

- The costs of maintaining the leases.
- The term remaining on all leases.
- Any option periods available on leases.
- Rental increase clauses inherent in leases.
- For real property leases, the existence of demolition clauses.
- For real property leases the existence of restrictions on the permitted use of premises, and;
- The existences of any security charges, liens or encumbrances associated with the underlying assets or real property.

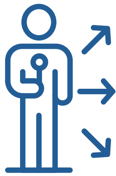


Technology and Patents

As part of due diligence, we recommend potential acquirers understand the intellectual property of the subject business or company and the nature of software and technology used by the business. This information should be considered in light of the impacts that technology or intellectual property matters may have on the short-and long-term performance of the business.

Specifically, we advise clients to review items such as:

- The nature of any patents that the business has.
- Trademarks held by the business.
- Copyrights held by the business.
- The costs of maintaining intellectual property of the business, and;
- The nature of software used and/or owned by the business and its costs.



Suppliers

As part of due diligence, we believe it is integral to properly understand the subject business or company's supply chains to ensure they are secure and to make sure supply-chain costs will not likely increase dramatically in the future.

Key supply-chain factors to be considered include:

- Gaining an understanding of the identity of a business or company's suppliers and any risks associated with specific suppliers due to their location or their own financial position.
- Assessing the nature of any exclusive supply arrangements and the costs, benefits and risks associated with such arrangements.
- Understanding any personal relationships that underpin specific supply arrangements and gauging the risks of retaining those supply lines following a change in the business or company's ownership, and;
- Investigating how supplier costs and terms are negotiated and considering the likelihood of supply cost increases in the future.

Corporate Matters

In our experience, it is vital to assess corporate risks as part of due diligence and manage these risks appropriately.

Specific items that we often review in assessing this risk include:

- Reviewing shareholder agreements with particular focus on items such as valuation clauses and non-compete arrangements between shareholders.
- Considering the impact of any security interests held over the assets of the business or company and how these may impact on the feasibility of a transaction.
- Understanding the nature of subsidiaries of the business and their roles.
- Forming a view on whether you should acquire the assets of the business or the shares in the company or companies which own the business, and;
- Reviewing the risks inherent in any previous restructures or recapitalisations of the business' corporate structure.

Environmental Issues

It is our view that it is vital to understand the risks of key environmental issues in any potential acquisition.

Some of the common environmental risk factors to consider include:

- Considering and investigating whether there are any hazardous substances or materials used in the operations of the business and how these may impact on your decision to acquire the business;
- Confirming the existence of requisite environmental permits and licences;
- Understanding the existence and nature of any environmental claims that have been made against the company, and;
- Understanding the nature of contractual obligations of the company with respect to environmental issues.

Other Factors

As noted throughout this comprehensive reference guide, the process of due diligence is not a one-size fits all approach. Instead, it is vital to consider the nature, risks and activities of the specific business or company that you are considering acquiring and conducting your investigations and research with that firmly in mind.

Some of the other common areas of consideration required when conducting due diligence not detailed above include:

- Considering the existence and risks of agreements in place with the vendor which restrict their ability to trade in a certain way or in a certain market.
- The nature of marketing initiatives undertaken by the business at hand, and;
- The existence of franchise agreements to which the business or company is a party to and their associated risks.

Due Diligence Report

While undertaking our due diligence process, we will prepare a due diligence report which outlines the scope of our works and inherent risk factors we have identified throughout the conduct of the due diligence. This ensures that our client is fully aware of any risk factors and can use these identified risks to ensure their final offer and key terms reflect the inherent risks that have been identified and try to mitigate any risks to a reasonable level.

Through the drafting of a due diligence report we set ourselves apart from general due diligence that is undertaken by your trusted advisors such as your accountant and ensure that our client is aware of all identified risk factors not just including the financial risk factors but also the non-financial risk factors which have such a large impact on whether the business purchase is in the best interests of the acquirer.

About Groves & Partners

Groves & Partners is a specialist business transaction advisory firm, offering expert advice to help our clients achieve success in the merger, acquisition, sale and valuation of medium-sized companies.

Groves & Partners has expertise in advising on transaction and valuation matters across a range of areas, including:

- Business sales, acquisitions and mergers (advice and execution)
- Business, company and shareholding valuations
- Exit planning advice and strategies
- Due diligence advice
- Business improvement and turnaround

With two convenient offices in Sydney and Brisbane, Groves & Partners focus on building long-lasting relationships and providing superior client service in a confidential, timely and cost-effective manner.

With our expertise and experience we can transact on national and international mergers, acquisitions and sales.

We understand that the quality of our work is a critical factor in earning your trust. Consequently, we strive to meet the highest professional standards. When you choose Groves & Partners, you can rest assured that you will benefit from our expert knowledge, our breadth of experience and advice, which ensures your matter will be dealt with in a thorough and professional manner.

Due Diligence Advisory Practice

Groves & Partners due diligence advisory practice is trusted by companies, private equity firms, family offices and other investors to provide a comprehensive and cost-effective due diligence solution for potential business and company acquisitions. Further, clients frequently retain our due diligence services because of referrals from accountants, lawyers and other advisors.

Our due diligence advisory practice incorporates our firm's strong track record of providing trusted and successful merger and acquisition execution services together with our detailed commercial know-how across financial investigations, business operational analysis and valuations. This provides our clients with a sensible, commercial and trustworthy solution for their due diligence needs.

Our due diligence team includes professionals with diverse backgrounds, including Chartered Accountants, Registered Business Valuers and merger and acquisition specialists.

Find Out More

If we may be able to assist with a due diligence investigation for you or your company, we welcome you to contact us to schedule an initial confidential, no-cost consultation. Call us today on 1300 892 717 or email info@groves.com.au.

Sydney

Level 7, 100 William Street
EAST SYDNEY NSW 2011

Brisbane

Corporate House Level 34,
1 Eagle Street
BRISBANE QLD 4000

info@groves.com.au

1300 892 717

ww.groves.com.au

Groves & Partners

INFORMATION SOURCES AND DISCLAIMERS

Groves & Partners Pty Ltd has relied on a range of information sources, including IBISWorld, Dun & Bradstreet's Company360, Standard & Poor's Capital IQ and a range of other publicly available information.

Our analysis and this report assume that the information derived from various sources is materially correct.

Groves & Partners Pty Ltd does not warrant or make any representations regarding the use or the results of the use of the materials in this document in terms of their correctness, accuracy, reliability, or otherwise.

Except where prohibited by law, Groves & Partners Pty Ltd will not be liable to you or any third party for any indirect, consequential, exemplary, incidental, special or punitive damages, including lost profit, loss of revenue, loss of goodwill, loss of customers, loss of capital, loss of or damage to reputation, loss under or in relation to any contract, loss of anticipated savings or benefits suffered or incurred by or awarded against you in any way connected with this document.